Offshore "Outsourcing"

LESS FEAR BUT STILL PLENTY OF LOATHING

BY ARTHUR W. WRIGHT

Three short years ago, when the U.S. economy was still in its "jobless recovery" from the 2001 recession, a hullabaloo erupted over the foreign "outsourcing" of services. Once the economy began expanding, however, offshore outsourcing lost some of its power as a bogey man. Yet politicians still inveigh against it in their quests for votes, reflecting the lingering conviction by fully three-quarters of the public that it's bad for America.

Offshore outsourcing—hereafter, offshoring—is but one manifestation of the terrible, swift sword of globalization driving competition, and productivity, throughout the world economy. As such, it generates significant gains for the economy of the nation and, with it, that of Connecticut. So it's important to resist the forces trying to check its progress.

At the same time, there is a central truth behind the resistance: Offshoring (like breaking eggs for a delicious omelet) imposes adjustment costs—layoffs, and the need to re-hone job skills or acquire new ones, perhaps even to relocate—on some workers and firms. The *complete* economic argument for keeping the national economy open is that we can compensate any losers out of the gains but still come out ahead. Failing to make the compensation will only strengthen the resistance and hence jeopardize the efficiency gains.

The skills of its workers and a strong education system kept the Connecticut economy resilient as it lost its edge in old-line manufacturing. But nowadays galloping technological change in communications is exposing an ever-widening circle of Connecticut's higher-tech jobs to foreign competition. Trying to prevent firms from making use of cheaper offshore services would just drive them—and their jobs—out of the state. But that's not to say that Connecticut companies, unions and public officials should sit idly and watch their jobs flow abroad. We have ways to meet this new challenge, but the time to act is now.

LEST WE FORGET

The Nutmeg State's ties to the international economy go way back. Since early days, Connecticut has looked abroad for workers, know-how, capital, and markets. Even with the unrelenting decline of manufacturing employment, our state still exports a lot of high-end manufactured goods—industrial machinery, optical and other precision gear, electrical machinery, and aircraft products, to name just the top dogs. But modern-day Connecticut also is a leading producer of many exportable services (information, education and financial). And our state continues to attract investment by foreign firms seeking access to our R&D capabilities and skilled workforce.

Connecticut also has a broader stake in the international economy. The main driver of state output and job growth is national economic performance, and the health of the U.S. economy depends to an increasing degree on international trade and finance. Hence, anti-offshoring policy measures would just shoot Connecticut and the U.S. in the foot, hobbling their other efforts to capitalize on the growing internationalization of the nation's economy.

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OFFSHORING DECONSTRUCTED

Offshoring refers to hiring from abroad what American-based firms used to do themselves or contract for ("outsource") at home. To economists, it is merely an extension of good old-fashioned Ricardian comparative advantage, where (in the early 19th century) the British produced cloth to trade for Portuguese wine. The far lower transportation and communications costs of today have opened up trade in intermediate products and services. So scholars like Gene Grossman and Esteban Rossi-Hansberg at Princeton now spin tales about trading *tasks* rather than the finished goods of David Ricardo's famous example. Increasingly, it pays to contract with foreign producers to perform many service tasks.

For example, as shown in the sidebar, estimates by analysts at McKinsey & Company report that, for every $1.00 of domestic cost moved offshore (to India in their reckoning), companies save $0.58, holding constant the quality of the services (http://mckinsey.com/mgi/reports/pdfs/rethinking/). Using micro-level data, Christopher Johann Kurz of the Federal Reserve Board staff has found that offshoring firms are significantly larger, more capital intensive, and more productive than their stay-at-home brethren (http://www.federalreserve.gov/pubs/feds/2006/200604/200604pap.pdf).

Taking advantage of offshoring opportunities is also good for the economy as a whole. The McKinsey study in my illustration found an additional benefit to the U.S. of $0.54: $0.05 in U.S. exports to India, plus $0.04 in repatriated profits from U.S. foreign investments, plus $0.45 in output produced by re-employed labor (assuming only partial rehiring). That pushes the gross gain from the offshoring of a dollar's worth of services to India of $1.12. Also, Mary Amiti and Shang-Jin Wei at the International Monetary Fund, again using American firm-level data, reported in a December 2005 working paper that offshoring services accounted for about one-eighth of the rapid growth of labor productivity in U.S. manufacturing, 1992-2000.

ROUGHHOUSING WITH AN 800-POUND GORILLA

Trouble is, the wonderfully productive global economy can be a bit too much like a friendly 800-pound gorilla—strong, to be sure, and fun to horse around with, but occasionally some playmates may get hurt.

The downside of U.S. firms' having service tasks done abroad is the destruction of jobs performing those same tasks in the U.S.—the $1.00 of services in the illustration. Brad Jensen and Lori Kletzer, writing in the 2005 *Brookings Trade Forum*, point out that tradable service jobs tend to be *higher-skilled* than non-tradable jobs. Jensen and Kletzer find a distinct "rise in the probability of job loss for more-educated workers" (page 76). To be sure, jobs in tradable services fetch earnings premia over those in non-tradable services, but many workers displaced from tradable-service jobs wind up taking new posts at lower earnings—and that, only after some months of unemployed searching. In 2001-2003, the share of IT and financial-professional-business services in total jobs lost nearly tripled—from 15% to 43%—compared with 1979-1982.

Information, financial, professional and business services are right in the wheelhouse of the modern-day Connecticut economy. According to U.S. Bureau of Economic Analysis estimates of Connecticut GDP in 2005, the three sectors of "information", "finance and insurance", and "professional and technical services" accounted for better than a quarter of our total output. And while Connecticut has continued to hemorrhage manufacturing jobs, growth in those services sectors has kept the state's economy vibrant. Of our GDP growth of 3.2% between 2004 and

OFFSHORING: WHO WINS, WHO LOSES?

Assume that a U.S. company "offshores" $1.00 worth of U.S. services to India, where the same services cost the firm $0.42 (labor, supervision, extra transaction costs).

Loss to U.S.		($1.00)
Gains to U.S		
Cost savings	$0.58	
Increase in Indian exports to U.S.	0.05	
Repatriated profits	0.04	
Value of re-employed labor	0.45	
Total U.S. Gains		1.12
Net gains to U.S.		$0.12
Gains to India (wages, taxes, profits)		0.33
Net global gains		$0.45

Source: McKinsey Global Institute.

2005, the Big Three services sectors accounted for 1.91 points, or 60%.

LIVE BY THE SWORD, DIE BY THE SWORD

So the "terrible, swift sword" of globalization turns out to be double-edged: Connecticut's very strength in tradable services means that the state is especially vulnerable to offshoring, and probably increasingly so as time passes. Cynthia Kroll, using a simple "location quotient" approach, found that, in 2003, Connecticut was in the top group of "high-risk" states in "technical", "office support" and "business/finance" services employment (http://repositories.cdlib.org/iber/fcreue/fcwp/293). Overall, Connecticut ranked third among the 50 states in exposure to services offshoring, with 13.7% of jobs at risk, just behind Delaware and Virginia; the 50-state average was 11.7%. Not surprisingly, Kroll found Hartford and Fairfield Counties to be among the most vulnerable metros in the U.S. because of their concentrations of jobs in those sectors.

If we'd rather live by the sword to continue to reap the benefits of offshoring, Connecticut policy makers (in league with those in other states and in Washington) need to find ways to compensate the losers and keep them from turning into opponents of free trade and an open economy.

I have to admit that the "fair-trade" lobby is right on one point: many of our trading partners (continental Europe, Japan) need to reduce their barriers to offshoring their tradable service jobs to us. Diana Farrell and Jaeson Rosenfeld of the McKinsey Global Institute, for example, reckon "that the US could eliminate up to a third of its current account deficit if countries in the EU imported as many services from the US as it imports from them" ("US Offshoring: Rethinking the Response", December 2005, page 9).

Farrell and Rosenfeld, along with others, recommend a two-pronged approach to compensating the victims of services offshoring. The first prong is to *strengthen and broaden the income cushion* in current policies. It is widely acknowledged that the U.S. has by far the highest re-employment rate for displaced workers among advanced countries. But the U.S. ranks way behind western Europe in the share of GDP spent on assistance to displaced workers—0.5%, compared with 3.1% in Germany and 3.7% in Denmark. Conventional unemployment insurance in the U.S. was designed to deal with business cycles, not foreign competition, and its extension to "trade-adjustment assistance" has suffered from political turbulence and chronic underfunding. According to Robert Litan and Lori Kretzer, a mere 4-5% of the cost savings to U.S. firms from outsourcing would provide wage insurance for displaced workers at 70% of lost wages (from time of severance to re-employment), and cover health insurance subsidies for two years into the bargain. (My illustration assumes 5% of $0.58, or $0.04.)

The second prong is to *better equip workers to adapt to job loss*, and not just after being displaced but during their formal educations as well. Half a century ago, graduate engineers began seeking MBAs to enable them to pursue careers in managing technical businesses. Today, systems analysts and software engineers need business and people skills to go with their technical prowess, if they are to survive the offshoring of technical services. Universities have already begun to offer multidisciplinary training in "services science".

Union and corporate leaders should be involved in both prongs of this approach—developing the wage and health-insurance replacement policies, and designing new training programs, to avoid the old trap of offering trade-school courses in disappearing occupations (often taught by displaced workers).

Three years ago, the hullabaloo over offshoring prompted Governor Rell to establish a "jobs cabinet" that (among other things) held hearings on the challenges posed by "outsourcing". As the hubbub ebbed, so apparently did State efforts to keep Connecticut's labor force nimble, creative, *and* employed. Perhaps with her recent landslide endorsement for a full term in her own right, Governor Rell will revive her interest in assisting displaced workers so that they can participate in the benefits from offshoring instead of becoming outspoken opponents of it.

Thomas Friedman wrote in his October 6, 2006, column in the *New York Times*: "Business rule No. 1 today is: Whatever can be done will be done, by someone, somewhere. The only question is whether it will be done by you or to you."